VELAN

ANNUAL REPORT 2003

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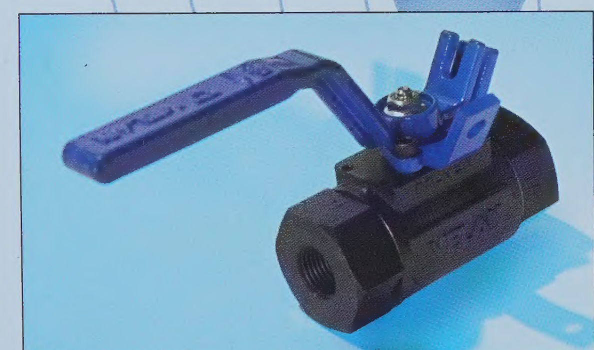
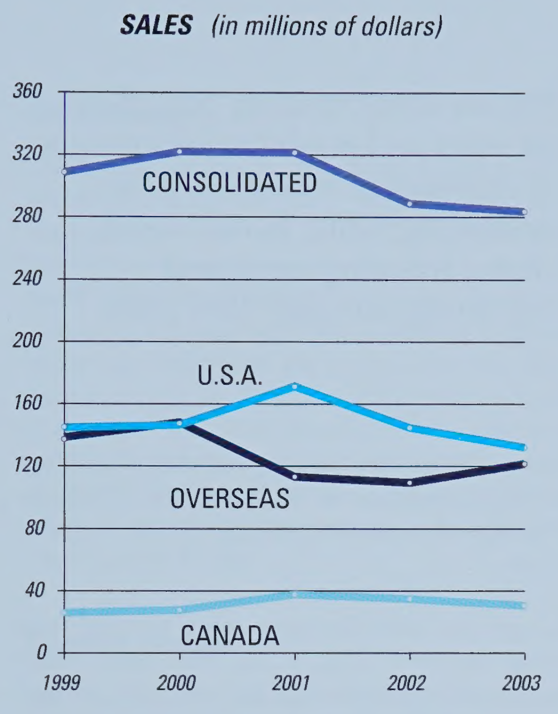
A.K. Velan inspects a butterfly valve at Velan S.A.S., our French subsidiary.

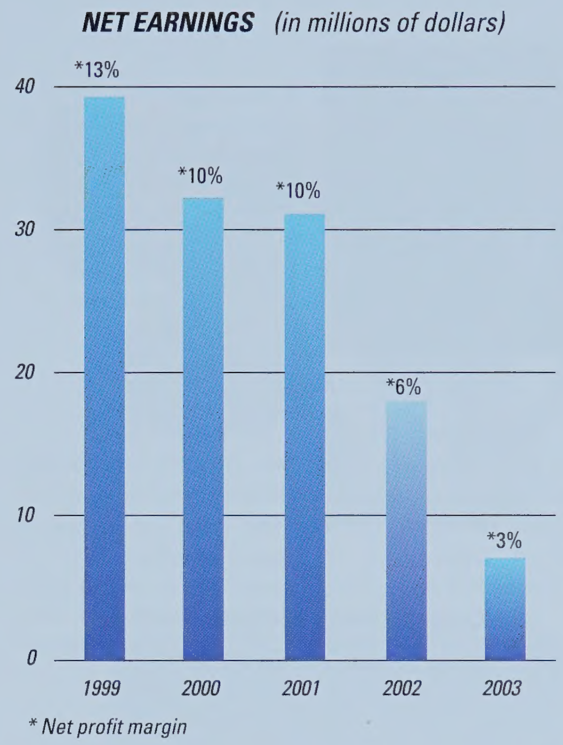


A prototype of Velan's new S3P API 6A high pressure ball valve.

Nuclear valves that are part of an order of over 5,000 valves destined for the Taiwan Power Lungmen station.

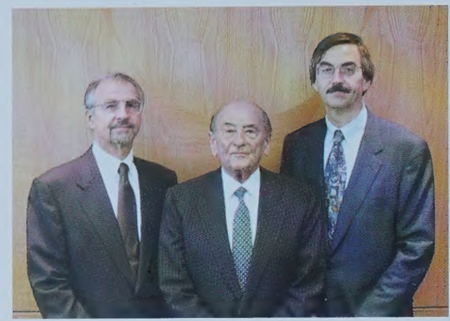
The Annual Report cover was designed from a close-up picture of valves from this shipment.





Year Ended May 31	2003	2002	2001	2000	1999
(in thousands of dollars, except per share amounts and number of employees)					
Income statement data					
Sales	$ 283,472	$ 288,466	$ 321,442	$ 321,567	$ 308,473
Gross profit	82,888	91,010	110,747	112,082	109,685
Gross margin	29.2%	31.5%	34.5%	34.9%	35.6%
Engineering, selling, general and administrative and research expenses	57,053	52,660	55,620	54,211	43,716
Earnings before income taxes	12,043	27,807	46,909	49,197	59,219
Net earnings	7,388	17,973	31,354	31,682	39,209
Net profit margin	3%	6%	10%	10%	13%
Earnings per share*	0.33	0.80	1.40	1.40	1.73
Balance sheet data					
Cash and short-term investments	$ 66,911	$ 42,175	$ 55,081	$ 43,134	$ 64,525
Working capital	195,477	193,360	188,018	163,488	165,741
Property, plant and equipment	57,249	56,835	57,585	59,947	49,411
Total assets	317,117	319,404	314,294	311,412	293,592
Total debt	4,556	7,694	6,513	8,091	21,926
Shareholders' equity	255,947	253,010	250,398	230,484	207,590
Number of employees					
Canada	810	899	901	876	877
United States	176	212	225	215	256
Overseas	416	381	374	384	249
Total	1,402	1,492	1,500	1,475	1,382

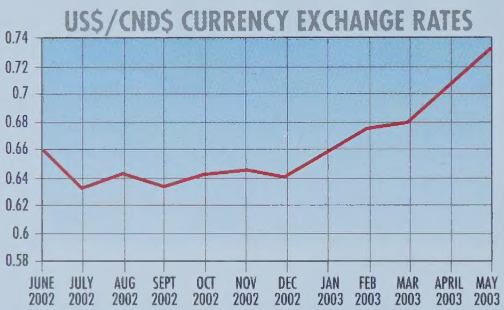
** see note 10 in the Notes to the Consolidated Financial Statements*



Left to right: Ivan Velan, Chairman of the Board and Executive Vice-President, North American Sales; A.K. Velan, Chief Executive Officer; and Tom Velan, President.

"We are concentrating our efforts on sales and product development of engineered industrial valves, optimizing value in our supply chain, reducing costs, and improving our cash flow cycle."

The results for our fiscal year 2002/03 were lower than anticipated due to continuing weakness in our major markets and the large impact of the decline in the U.S. dollar against the Canadian dollar.



Foreign Exchange Impact

During our fiscal year, the Canadian dollar rose 11.7% against the U.S. dollar. We have three integrated subsidiary operations which, according to Canadian GAAP, have to be consolidated using the temporal method. As a result, our low net income of $7.4 million compared to $18 million last year was partly caused by an unrealized foreign exchange loss of $5.1 million compared to an exchange loss of $0.2 million the previous year. Although we cannot hedge against such a currency loss on consolidation, we do have a hedging policy that helps to reduce the extent of our currency risk exposure on our U.S. dollar transactions.

Revenues, Backlog and Order Bookings

Our sales revenues of $283.5 million were down 1.7% from last year. Our order bookings of $280.4 million were at nearly the same level as last year's $281 million, but lower than sales, which resulted in a backlog decline of $3.7 million to $114.4 million. The backlog and order bookings were highly impacted by the fall in the U.S. dollar but partly offset by the increase in the value of the euro.

Although our sales revenues, order bookings and backlog declined slightly, we did have many important successes during the year. We booked more than 190 project orders around the world and strengthened our distribution channel with the addition of McJunkin Corporation, one of the largest pipe, valves and fitting distributors in the U.S. We also signed new MRO supply agreements with two of the largest oil companies in the U.S. and with one of the largest pulp and paper companies. Even though our sales in the North American market declined by 9.6%, this was partly offset by an 11.1% increase in sales to other countries.

Profitability

Our profit margin declined from 6.2% to 2.6%. The majority of this decline is attributable to our North American operations and for the first time in our history, our overseas subsidiaries contributed the majority of our net profit. The low profit in North America was strongly impacted by the $5.6 million unrealized loss in exchange in consolidation of our U.S. subsidiary (see note 13(b) of our financial statements) as well as a $2.1 million under-absorption of labour and overhead. These two factors explain $7.7 million of the reduction in after-tax profits in our North American operations. The profit margin was also lower because the majority of revenues are in U.S. dollars while the costs, other than material, in our Canadian operations are in Canadian dollars.

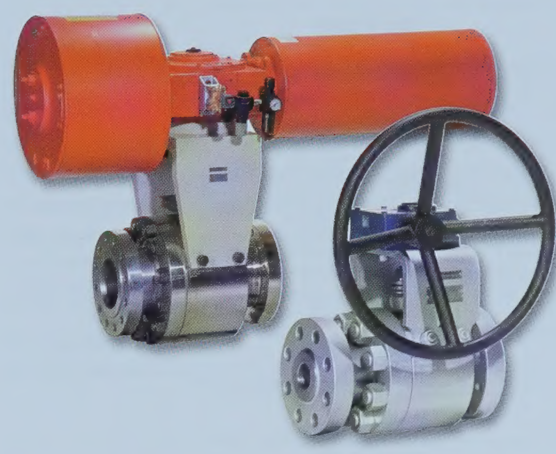
Restructuring

Due to the decline in our North American results including sales revenues, backlog, and order bookings, we have had to layoff 125 people in our North American operations and at the same time made investments towards improving productivity. Reducing our workforce was a difficult decision to make and we regret the impact on the affected employees and their families. It is a great challenge to compete in the valve manufacturing business with our North American production against lower-cost countries and we have to significantly improve productivity in all our operations to better compete in our global market.

Financial Strength

We have a strong balance sheet with a shareholders' equity of $255.9 million, or $11.46 per share. Our cash position increased to $66.9 million from $42.2 million at the start of the fiscal year. The increase in cash is due mainly to reductions in accounts receivable and the decrease in inventory.

API 6D/6A pipeline ball valves for the upstream oil and gas markets.



Two of Velan's Securaseal Metal-Seated Ball Valves: "N" Type for severe service and "R" Type for high pressure.

New Products/New Opportunities

We have entered into a joint venture to produce API 6D/6A pipeline ball valves in Italy. At the same time, we have developed a line of API 6A high-pressure oilfield ball valves. These two new product lines open up new opportunities for us in the upstream oil and gas markets where we have sold very little in the past. This is a huge market with considerable growth potential for Velan.

Our new joint venture has already manufactured an order for an offshore platform in South America and has also booked other significant project orders. We plan to also manufacture these pipeline ball valves for the North American market in our North American plants in the future.

In the past few years we have introduced several new product lines and extensions to our existing product range, including our Torqseal triple offset butterfly valves, power ball valves, severe service "R" type metal-seated ball valves, and HF Acid valves. We have not yet achieved an acceptable market share in these valves and we are working hard to realize our potential in these new products.

Management Changes

In May 2003, we made important changes in the management structure of the Company. The Board of Directors appointed Tom Velan as President and Ivan Velan as Chairman of the Board. A.K. Velan is continuing in his position of CEO.


Certificate of Approval

Awarded to

VELAN, INC.
2125 WARD AVENUE, MONTREAL, QUEBEC, CANADA, PLANT 1
550 MCARTHUR AVENUE, MONTREAL, QUEBEC, CANADA, PLANT 2
1010 COWIE STREET, GRANBY, QUEBEC, CANADA, PLANT 4
7007 COTE DE LIESSE, MONTREAL, QUEBEC, CANADA, PLANT 5

VELAN VALVE CORPORATION
94 AVENUE "C", WILLISTON, VERMONT U.S.A.

Bureau Veritas Quality International (NA) Inc. certifies that the Quality Management System of the above organization has been assessed and found to be in accordance with the requirements of the standards and scope of supply detailed below.

QUALITY STANDARDS

ISO 9001:2000

SCOPE OF SUPPLY

DESIGN, MANUFACTURE AND DISTRIBUTE CAST OR FORGED STEEL GATE, GLOBE, CHECK, BALL, BUTTERFLY AND KNIFE VALVES FOR COMMERCIAL INDUSTRIES.

Original Approval Date: 21 MAY 1991

Original Approval Date for ISO 9001:2000: 28 MAY 2003

Subject to the continued satisfactory operation of the organization's Quality Management System, this certificate will remain valid until:

21 MAY 2006

Issue Date: 28 MAY 2003

Certificate No: 127436

ANSI-RAB QMS ACCREDITED

For Bureau Veritas Quality International (N.A.) Inc.
515 West 5th Street, Jamestown, New York, U.S.A.

The ISO 9001:2000 certificate of approval for all of Velan's North American plants.

As part of the new management organization, many of our executives and managers have been given additional responsibilities and they have reacted very positively to the new challenges.

We have a strong management team including 13 Vice-Presidents with an average of 18 years' experience with the Company.

All our plants were approved to ISO 9001:2000 this year. This new quality program includes the requirement to measure and improve customer satisfaction. We have established performance targets related to product quality and on-time delivery of our products and services, and we will need a concerted effort by all employees to achieve and hopefully surpass these targets. We want to thank all our employees for their efforts and hard work in a challenging year. It will take the continuing commitment and determination of every employee to achieve our goals.

Velan's Leadership Training Program provided 15 foremen from production plants in Montreal an opportunity to share experiences and focus on the role of the supervisor and improving performance.

Outlook

These are challenging times for our Company and the valve industry as a whole. We continue to encounter fierce competition from valve manufacturers in low-wage countries, particularly from Asia. We have to differentiate ourselves from these competitors by stressing the superior quality and performance of our products, which offer our customers competitive value through lower long-term cost of ownership.

The editorial in a recent issue of the VMA's magazine was entitled "Industry in the Doldrums" and starts out with a statement that "there aren't too many smiling faces in the valve industry nowadays". The difficult market has also made end-users and architect/engineers introduce aggressive cost cutting measures with increased expectations from their suppliers.

We are concentrating our efforts on sales and product development of engineered industrial valves, optimizing value in our supply chain, reducing costs, and improving our cash flow cycle. We are also expanding our product offering to open opportunities in new markets and increasing our sales efforts in niche markets for severe service valves. We want to be a more cost efficient and productive company, ready to benefit from an upturn in our major markets.

A. K. Velan
Chief Executive Officer

T. C. Velan
President

I. C. Velan
Chairman of the Board and Executive Vice-President, North American Sales

Overview

The consolidated financial statements of Velan Inc. include the North American operations of Velan Inc. and Velan-Proquip Inc. in Canada and Velan Valve Corp. in the U.S.A. The overseas operations include Velan S.A.S., France; Velan Ltd., Korea; Velan Valvulas Industrias Lda., Portugal; Velan GmbH, Germany; Velan Valves Limited, U.K.; and Velan Valvac Co. Ltd., Taiwan. In addition, we have two foundries overseas which are joint ventures of our Korean and Taiwanese subsidiaries. These joint venture companies are reported using the proportionate consolidation method of accounting.

The relative value of the U.S. dollar against our Canadian currency has a major impact on the results as shown in these financial statements. In the latter part of our fiscal year the U.S. currency weakened rapidly against the Canadian dollar. It has still not recovered to levels of the prior year and its impact is seen in the $5.1 million unrealized loss on translation of our integrated subsidiaries. Further details of its effect can be obtained in Note 13(b) to these statements.

Corporate Investments

For many years we had a 50% ownership in Velan Valvac, a Taiwanese valve manufacturer of ball valves, which was accounted for using the proportionate consolidation method. We increased our investment to the 75% level for approximately $1.6 million effective the beginning of this year. Accordingly, the operations are now fully consolidated as a subsidiary and the 25% non-controlling interest's share has been segregated.

In August of last year we completed the acquisition of certain assets of Plenty Steam Products located in the U.K. for approximately $0.6 million. The company manufactured for 18 years the Velan steam trap line which we now repurchased adding it to our already extensive line of industrial valves.

Just prior to our May 2003 year-end the Company entered into a 50% joint venture arrangement in Italy to manufacture pipeline API 6D/6A ball valves. The Italian joint venture commenced production subsequent to our year-end and has already recorded revenues by August 2003.

More details on the current year's acquisitions can be found in Note 2 to the accompanying financial statements.

Review of Operations

Sales for 2003 were $283.5 million, or 1.7% below the previous year's sales of $288.5 million. Reductions in volumes and in base U.S. pricing were seen in our North American and Korean plants in addition to the devaluation of the U.S. dollar. The results were partially offset by increases in our European subsidiaries (U.K., France, Portugal and Germany) in revenues and in the strengthening of the euro against the Canadian dollar. The Plenty Steam Products acquisition made in August 2002 contributed an additional $1.8 million in revenues for the current year.

Incoming order bookings for the year were $280.4 million, being approximately the same as the previous years at $281 million. Our year-end backlog is $114.4 million, a reduction of 3% from last year's $118.1 million. Since the majority of our backlog is U.S. dollar based, it has been affected by a negative foreign exchange impact. If the U.S. dollar strengthens against the Canadian dollar, the backlog denominated in the U.S. currency will increase proportionately.

Total gross profit for the year of $82.9 million or 29.2% of sales compares to $91 million or 31.5% last year. The reduced level of gross profit resulted partly from a decrease in volume including currency impacts, but more significantly from increases in our raw material, labour and overhead costs in North America.

Due to the time lag between purchasing of material and shipping the final products, our costs of raw materials purchased earlier in U.S. dollars carried a much higher currency conversion rate than did the sales revenue generated due to the declining U.S. dollar value. This caused a much higher Canadian dollar material cost in relation to the Canadian dollar sales revenues. In addition, as communicated during the year, the excess capacity in certain plants resulted in under-absorbed costs of labour and production overheads, which also had a negative impact. As we were attempting to reduce both our workforce and our inventory levels to be in line with production orders, we absorbed approximately $3.1 million of these costs directly impacting this year's results. Conversely, in the previous year as we were building up finished goods inventories, we benefited from a $3.1 million efficiency reduction of these costs. The recurrence of these material and production cost levels will be influenced by the stability of exchange rates and production efficiencies.

Our engineering, selling, general and administrative costs have climbed to $57.1 million from $52.7 million last year or 8%. This level is unusually high and includes certain costs that, we believe, will not reoccur. Our exposure to bad debts has increased significantly this year particularly in our U.S. power market, which is in a downturn following the Enron failure. Unanticipated losses of $0.7 million above our normal levels were incurred. Severance costs of $0.6 million, outside consulting services of $0.3 million and unusually high commission payments of $1 million extra are the major variances. The increased commission costs are the result of a higher percentage of sales destined to overseas countries.

The interest expenses year over year remain relatively constant and at very low levels. Given our existing cash levels and anticipated expenditures, we do not anticipate any significant bank borrowings for the next year.

Amortization costs of $9.4 million have been reduced by $2.5 million from last year's level of $11.9 million. The largest reduction of $1.7 million comes from the adoption during this year of the new accounting recommendation regarding goodwill. In the past, goodwill amounts were capitalized and amortized to earnings over a number of years. The new recommendation requires that an assessment of any impairment to the value be performed annually with an initial adjustment being taken against opening retained earnings, as we have done this year in the amount of $0.4 million net of future taxes. (See Note 1 to the consolidated financial statements for more details.) The balance of the reduction is attributable to reduced amortization charges on property, plant and equipment.

Other income is for the most part interest generated from our cash investments. Our policy is to invest in short-term no-risk investments which, by their very nature, result in lower returns.

The foreign exchange losses of $5.1 million this year ($0.23 EPS), resulting from translation of our integrated subsidiaries, compare to $0.2 million ($0.01 EPS) in 2002. These exchange losses are unrealized as yet, but it is required by Canadian accounting principles to be calculated and reported as such in our earnings statement. These exchange adjustments relate to our U.S., Korean and Taiwanese companies. Our other subsidiaries in the U.K., France, Germany and Portugal are considered to be self-sustaining. Their exchange adjustments are required to be deferred on the balance sheet in the shareholders' equity section and as such we have a deferred gain this year of $1.9 million compared to a $1.2 million deferred loss in the prior year. (See Note 1 to the consolidated financial statements for more details).

The foreign exchange loss on our integrated subsidiaries has significantly impacted our results this year and its effect on EPS is shown below.

	2003	2002
Earnings per share as reported	$ 0.33	$ 0.80
Foreign exchange loss on translation of integrated subsidiaries	0.23	0.01
	$ 0.56	$ 0.81

Our effective tax rate based on the reported amounts in our financial statement is 38.7% this year compared to 35.4% in 2002. Included in the earnings statement are certain large non-tax recognized items, which are the foreign exchange losses and goodwill amortization costs. After adjusting for these amounts, the current tax rate drops to 27.1% compared to 33.1% in 2002. Our expected tax rate is in the low to mid 30% range, taking into account profit levels and country of origin. The abnormally low rate in 2003 is mainly a result of tax effecting in the current year certain losses carried forward of a subsidiary.

Our net earnings this year of $7.4 million or $0.33 per share is a large reduction from the $18.0 million or $0.80 per share last year. Reduced selling prices, foreign exchange losses, excess capacity in our plants, unusually high levels of customer bad debts and non-recurring severance costs have all impacted negatively our results. As management we have taken appropriate steps to control costs and reduce our workforce in an effort to return to better profitability.

Liquidity and Capital Resources

Our cash has increased by $24.7 million this year, attaining $66.9 million at year-end. The main reasons for this increase came from our efforts to reduce inventories and accounts receivable. Reduced capital expenditures and dividend payments year over year also helped to achieve this level. For the next year known cash requirements are limited to capital equipment needs at similar levels as 2003. A further $0.6 million will be invested in our new Italian joint venture as initial capital.

Capital Expenditures

No unusual capital expenditures were made during the year and were actually at a slightly reduced level from the prior year's amounts. Outside of minor equipment replacements, the only other anticipated expenditures relate to our plans for improving productivity at our North American plants.

Risks and Uncertainties

The Company deals on a global basis and is subject to certain risks, which include currency fluctuations. The majority of our worldwide revenues and certain manufacturing costs are denominated in the U.S. currency. The net difference between our sales and costs are not naturally hedged, which can lead to significant operational exchange losses being incurred, as we have experienced this year. The Company contracts with financial institutions forward exchange contracts to hedge some of this exposure.

Management Report

Preparation of the consolidated financial statements accompanying this annual report and the presentation of all other information in this report is the responsibility of the management of Velan Inc. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles, using management's best estimates and judgments. All other financial information in this report is consistent with that contained in the financial statements.

Management is also responsible for maintaining a system of internal controls designed to provide reasonable assurance that assets are safeguarded and that accounting systems provide timely, accurate and reliable financial information.

The Board of Directors is responsible for ensuring that management fulfils its responsibilities for financial reporting and internal control.

The Board is assisted in exercising its responsibilities through the Audit Committee of the Board which is composed of two non-management directors and Mr. Ivan Velan, Executive Vice-President, North American Sales. The Committee meets periodically with management and the auditors to satisfy itself that management's responsibilities are properly discharged, to review the financial statements and to recommend approval of the financial statements to the Board.

PricewaterhouseCoopers LLP, the independent auditors, have audited the Company's financial statements in accordance with Canadian generally accepted auditing standards and their report follows. The independent auditors have full and unrestricted access to the Audit Committee to discuss their audit and their related findings as to the integrity of the financial reporting process.

T. Velan
President

S.R. Farrell
Executive Vice-President, Finance and Information Technology
Chief Financial Officer and Corporate Secretary

September 4, 2003

Auditors' Report

To the Shareholders of
Velan Inc.

We have audited the consolidated balance sheets of Velan Inc. as at May 31, 2003 and 2002 and the consolidated statements of earnings, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial positions of the company as at May 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

Montréal, Canada
August 8, 2003

Consolidated Balance Sheets

As at May 31, 2003 and 2002 (in thousands of dollars)

	2003	2002
Assets		
Current assets		
Cash and cash equivalents	$ 66,911	$ 42,175
Accounts receivable	68,658	83,767
Income taxes recoverable	2,553	3,039
Inventories (note 3)	103,738	118,177
Deposits and prepaid expenses	1,934	1,561
Advance to an affiliated company (note 16)	280	-
Future income taxes (note 7)	2,057	159
	246,131	248,878
Property, plant and equipment (notes 4 and 8)	57,249	56,835
Goodwill (note 1)	12,502	13,030
Other assets	1,235	661
	$ 317,117	$ 319,404
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 6)	$ 40,614	$ 42,104
Customers' deposits	2,390	4,667
Provision for performance guarantees (note 15(a))	6,473	6,597
Current portion of long-term debt (note 8)	1,177	2,150
	50,654	55,518
Future income taxes (note 7)	1,679	2,030
Long-term debt (note 8)	3,379	5,544
Non-controlling interest (note 2(a))	1,623	-
Other long-term liabilities	3,835	3,302
	61,170	66,394
Shareholders' Equity (note 9)		
Capital stock (note 9)	109,594	110,035
Contributed surplus	1,368	1,323
Retained earnings	143,124	142,836
Foreign exchange translation adjustments	1,861	(1,184)
	255,947	253,010
	$ 317,117	$ 319,404

Approved by the Board of Directors,

Director

Director

Consolidated Statements of Earnings

For the years ended May 31, 2003 and 2002 (in thousands of dollars, excluding per share amounts)

	2003	2002
Sales (note 12)	$ 283,472	$ 288,466
Cost of sales (note 13(a))	200,584	197,456
Gross profit	82,888	91,010
Expenses (other income)		
Engineering, selling, general and administrative and research (note 14)	57,053	52,660
Interest		
Long-term debt	270	237
Other	230	231
Amortization of property, plant and equipment and goodwill (note 1)	9,351	11,901
Other income	(1,191)	(2,025)
Foreign exchange loss on translation of integrated subsidiaries (note 13(b))	5,132	199
	70,845	63,203
Earnings before income taxes	12,043	27,807
Provision for (recovery of) income taxes (note 7)		
Current	6,184	10,568
Future	(1,529)	(734)
	4,655	9,834
Net earnings for the year	$ 7,388	$ 17,973
Earnings per share (note 10)		
Basic	$ 0.33	$ 0.80
Diluted	$ 0.33	$ 0.80

Consolidated Statements of Retained Earnings

For the years ended May 31, 2003 and 2002 (in thousands of dollars)

	2003	2002
Retained earnings – Beginning of year		
As previously reported	$ 142,836	$ 141,633
Adjustment for change in accounting policy (note 1)	(400)	-
As restated	142,436	141,633
Net earnings for the year	7,388	17,973
	149,824	159,606
Dividends		
Multiple Voting Shares	4,750	11,930
Subordinate Voting Shares	1,950	4,840
	6,700	16,770
Retained earnings – End of year	$ 143,124	$ 142,836

Consolidated Statements of Cash Flows

For the years ended May 31, 2003 and 2002 (in thousands of dollars)

		2003	2002
Cash flows from			
Operating activities			
Net earnings for the year		$ 7,388	$ 17,973
Items not affecting cash			
Amortization (note 1)		9,351	11,901
Future income taxes		(1,529)	(734)
Gain on disposal of property, plant and equipment		(29)	(23)
Non-controlling interest		67	-
Net change in other long-term liabilities		541	529
		15,789	29,646
Net changes in non-cash working capital items			
Accounts receivable		15,628	(3,189)
Income taxes recoverable		478	1,399
Inventories		15,632	(18,401)
Deposits and prepaid expenses		(361)	(135)
Accounts payable and accrued liabilities		(1,896)	723
Customers' deposits		(2,244)	1,119
Provision for performance guarantees		(122)	(368)
		27,115	(18,852)
		42,904	10,794
Investing activities			
Net assets of business acquisitions (note 2)	(2,170)		
Less: Cash and cash equivalents acquired	154	(2,016)	-
Additions to property, plant and equipment		(7,086)	(8,714)
Proceeds on disposal of property, plant and equipment		325	52
Advance to an affiliated company		(280)	-
Net change in other assets		(427)	114
		(9,484)	(8,548)
Financing activities			
Repurchase of shares		(396)	(33)
Dividends		(6,704)	(16,770)
Increase in long-term debt		2,466	3,540
Repayment of long-term debt		(5,852)	(2,646)
		(10,486)	(15,909)
Effect of exchange rate differences on cash and cash equivalents		1,802	757
Net change in cash and cash equivalents		24,736	(12,906)
Cash and cash equivalents – Beginning of year		42,175	55,081
Cash and cash equivalents – End of year		$ 66,911	$ 42,175
Supplemental information			
Interest paid		$ 571	$ 548
Income taxes paid		$ 7,485	$ 11,318

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

1 Summary of accounting policies

Principles of consolidation

These financial statements represent consolidation of the accounts of the parent company and all subsidiary companies. They also include the accounts of joint venture companies using the proportionate consolidation method. Except for Velan-Proquip Inc., all subsidiary and joint venture companies are located in foreign jurisdictions.

Velan Valvac Manufacturing Co. Limited is the only group company with a December 31 fiscal year-end. Consolidated earnings include the company's share of results of its operations to that date.

Cash and cash equivalents

Cash equivalents include all highly liquid investments with original maturities of three months or less.

Inventories

Inventories are valued at the lower of cost and market. Market is defined as net realizable value. Cost is determined as follows:

a) raw materials using principally the weighted average method; and

b) finished parts and finished goods using principally the weighted average method plus applicable direct labour and manufacturing overhead.

The value of obsolete or unmarketable inventory is based on the company's assessment of market conditions for its products determined by historical usage, estimated future demand and, in some cases, the specific risk of loss on specifically identified inventory.

Property, plant and equipment

Property, plant and equipment is stated at cost less related government assistance. Provision for amortization is principally determined using the following methods and annual rates or terms:

	Method	Rate/term
Buildings	Declining balance	4% – 5%
Machinery and equipment and furniture and fixtures	Declining balance	10% – 31%
Data processing equipment	Straight-line	3 years
Rolling stock	Declining balance	30%
Leasehold improvements		Over the term of the leases

Goodwill

Goodwill relates to the excess of the purchase price over the fair value of the net assets acquired. Effective June 1, 2002, goodwill is no longer amortized to earnings but tested for impairment annually or more frequently if certain impairment indicators arise. Impairment is tested by comparing the fair value of the goodwill to its carrying value. The fair value is determined through the use of earnings multiples and discounted future cash flows. Any excess of carrying value over fair value is charged to earnings in the period in which the impairment is determined.

Prior to June 1, 2002, goodwill was amortized to earnings on a straight-line basis over varying terms not exceeding 20 years and was assessed for future recoverability by estimating future net undiscounted cash flows and residual values.

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

Investment tax credits

Investment tax credits are accounted for using the cost reduction method. Under this method, assistance relating to eligible expenditures is deducted from the cost of the related assets or related expenses in the period during which the expenditures are incurred, provided there is reasonable assurance of realization.

Customers' deposits

Customers' deposits are funds received in advance for contracts for which revenue has yet to be recognized.

Revenue recognition

Revenue is recognized when significant risks and benefits of ownership are transferred, the sales price to the customer is fixed or is determinable and collection of the resulting receivable is reasonably assured. The significant risks and benefits of ownership are normally transferred; for the sale of products, in accordance with the shipping terms agreed to with the customer and for the sale of services, as the services are rendered.

Research and development costs

Research and development costs are expensed as incurred unless the development costs meet the generally accepted criteria for deferral. As at May 31, 2003 and 2002, no costs have been deferred in the accounts of the company.

Income taxes

The company uses the liability method of accounting for income taxes. Future income taxes are provided for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes, computed based on rates and provisions of enacted or substantively enacted tax laws that are expected to be in effect in the year in which the differences are expected to be recovered or settled. The company reviews the valuation of its future income taxes and records adjustments, if necessary, to reflect their realizable amount.

Translation of accounts of foreign subsidiary and joint venture companies

Integrated foreign operations

The financial statements of Velan Inc.'s integrated foreign subsidiaries are translated using the temporal method. Under this method, monetary assets and liabilities are translated at year-end rates and non-monetary assets and liabilities at rates prevailing at the transaction dates. Revenue and expenses (other than amortization, which is translated at the rate applicable to the related asset) are translated at the average rate for the year. Gains and losses arising on translation are included in earnings for the year (note 13(b)).

Self-sustaining foreign operations

The financial statements of Velan Inc.'s self-sustaining foreign subsidiaries and joint venture companies are translated using the current rate method. Under this method, all assets and liabilities are translated at year-end rates and revenue and expenses at the average rate for the year. Resulting gains and losses are deferred and included in a separate component of shareholders' equity described as "Foreign exchange translation adjustments".

Currency risks

The company is exposed to currency risks due to the potential variation of the currencies in which the foreign subsidiaries and joint venture companies operate.

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

Foreign exchange translation

Foreign currency balances and transactions are translated using the temporal method. Under this method, all monetary assets and liabilities in foreign currencies have been translated at year-end rates. Non-monetary assets are translated at rates prevailing at the transaction dates. Revenue and expenses in foreign currencies have been translated at weekly rates throughout the year. Gains and losses arising on translation are included in earnings for the year.

Use of significant accounting estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies at the balance sheet dates as well as the reported amounts of revenue and expenses during the reporting periods. Actual results may differ from those estimates.

Credit risk

The company performs a continuous evaluation of its customers' credit and records an allowance for doubtful accounts as required. In performing its evaluation, the company analyzes the ageing of accounts receivable, concentration of receivables by customer, customer creditworthiness and current economic trends.

Derivative financial instruments

A majority of the company's revenues and a portion of its manufacturing costs are denominated in U.S. dollars. The company uses simple foreign currency forward contracts to hedge a portion of this net exposure. The effectiveness of the hedge is assessed both when the hedge is put into place and on an ongoing basis. Management considers the hedges to be effective and thus accounts for the contracts in accordance with the requirements of hedge accounting. Since the company is hedging a monetary item, any exchange gain or loss on the hedge is offset against the corresponding exchange loss or gain on the hedged item (note 15(d)).

Fair value of financial instruments

The company has evaluated the fair values of its financial instruments based on the current interest rate environment, related market values and current pricing of financing instruments with comparable terms. The carrying value of its financial instruments is considered to approximate fair value, unless otherwise indicated.

Stock-based compensation plans

The company has chosen not to apply the fair value method of recording stock options granted to certain full-time employees, directors and officers of the company and its subsidiaries. The company only grants stock options to employees that are settled in stock and, as such, no compensation cost has been recognized for the share option plan because at the date of grant there was no intrinsic value. Consideration paid by employees on the exercise of options is credited to capital stock. Pro forma amounts have been disclosed in the notes to the consolidated financial statements (note 9(e)).

Provision for performance guarantees

Provision for performance guarantees includes warranties for product failure and, in some cases, guarantees for on-time delivery. In certain cases, this will result in the company issuing a performance bond to its customers (note 15(a)). The company estimates its exposure under these obligations based on an analysis of all identified or expected claims and an estimate of the cost to resolve those claims. The estimates of expected claims are generally a factor of historical trends.

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

Comparative figures

Certain comparative figures have been restated to conform to the current year's basis of presentation.

Adoption of new accounting pronouncements

a) Goodwill and other intangible assets – On June 1, 2002, the company adopted the new recommendations of the Canadian Institute of Chartered Accountants ("CICA") regarding goodwill and other intangible assets. Under this standard, which can only be applied prospectively, goodwill and intangible assets with an indefinite life are no longer amortized but are tested for impairment annually, or more frequently if certain indicators arise. Upon adoption of these recommendations, a transitional impairment test on goodwill must be conducted on the value as at the beginning of the current fiscal year and the impairment loss, if any, charged directly to opening retained earnings. A transitional impairment, relating to the Canadian operations, of $400 ($528, net of future tax of $128) was charged to opening retained earnings.

The following table presents the results on a comparable basis:

	2003	2002
Reported net earnings	$ 7,388	$ 17,973
Adjustment for goodwill amortization – net of tax	–	1,688
Adjusted net earnings	$ 7,388	$ 19,661
Basic and diluted earnings per share as reported	$ 0.33	$ 0.80
Basic and diluted earnings per share as adjusted	$ 0.33	$ 0.88

b) Stock-based compensation – On June 1, 2002, the company adopted, giving retroactive treatment to awards granted in fiscal 2002, the new recommendations of the CICA regarding stock-based compensation and other stock-based payments. Under this standard, stock-based payments to non-employees and to employees which are direct awards of stock that call for settlement in cash or other assets or stock appreciation rights that call for settlement by the issuance of equity instruments must be accounted for using the fair value based method of accounting. The standard further recommends, but does not require, use of the fair value based method for other stock-based compensation. Where the fair value based method is not used, the standard requires disclosure of pro forma net earnings and pro forma earnings per share as if the fair value based method of accounting had been used. The fair value based method of accounting uses an option pricing model to determine the fair value of stock options granted which is then amortized over the vesting period as employees' services are rendered. The company has chosen not to adopt the fair value based method of recording the stock options granted to employees and therefore, the new recommendations have had no effect on its balance sheet or net earnings. The pro forma amounts have been disclosed in the notes to the consolidated financial statements (note 9(e)).

c) Foreign currency translation – Effective for the current fiscal year, the CICA has issued new recommendations, to be applied retroactively, eliminating the deferral and amortization of exchange gains and losses arising from the translation of long-term debt and other long-term monetary items. The adoption of this new requirement did not have any impact on the company's financial statements except for expanded disclosure (note 13(a)).

d) Guarantees – During the year, the company adopted the new guideline of the CICA regarding the disclosure of guarantees. Under this new guideline, certain disclosures must be made concerning specific types of guarantee contracts which require payments contingent on specific future events. The company only issues guarantees relating to product warranty and on-time delivery, which are exempt from this guideline. However, the company does provide certain disclosure regarding its guarantees (note 15).

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

2 Business acquisitions

a) Effective June 1, 2002, the company acquired an additional 25% interest in its Taiwanese joint venture company for a cash consideration of $1,556 (NT$34,144).

The acquisition has been accounted for using the purchase price method and the purchase price was allocated as follows:

Current assets	$ 936
Property, plant and equipment	1,034
Other non-current assets	136
	2,106
Current liabilities	(393)
Long-term debt	(157)
	$ 1,556

The company now owns 75% of the common stock in this Taiwanese company, which is now consolidated in the accounts with an amount equal to the non-controlling interest's share being recorded. As a result of the acquisition, the company has commenced translating the accounts of this foreign subsidiary as an integrated operation as opposed to a self-sustaining operation. This change has been accounted for prospectively.

b) In August 2002, the company acquired certain of the net assets of a steam trap manufacturer located in the United Kingdom for a cash consideration of $614 (£255).

The acquisition has been accounted for using the purchase price method and the purchase price was allocated as follows:

Current assets	$ 555
Property, plant and equipment	192
	747
Current liabilities	(133)
	$ 614

3 Inventories

	2003	2002
Raw materials	$ 22,631	$ 24,808
Finished parts	45,542	52,980
Finished goods	35,565	40,389
	$ 103,738	$ 118,177

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

4 Property, plant and equipment

Property, plant and equipment consists of the following:

2003

	Cost	Accumulated amortization	Net
Land	$ 11,082	$ -	$ 11,082
Buildings	31,120	13,674	17,446
Machinery and equipment	99,724	72,878	26,846
Furniture and fixtures	4,588	3,895	693
Data-processing equipment	11,580	10,854	726
Rolling stock	1,007	676	331
Leasehold improvements	253	128	125
	$ 159,354	$ 102,105	$ 57,249

2002

	Cost	Accumulated amortization	Net
Land	$ 9,996	$ -	$ 9,996
Buildings	29,614	11,950	17,664
Machinery and equipment	93,256	66,140	27,116
Furniture and fixtures	4,400	3,594	806
Data-processing equipment	11,054	10,189	865
Rolling stock	1,102	762	340
Leasehold improvements	131	83	48
	$ 149,553	$ 92,718	$ 56,835

5 Credit facilities

a) Velan Inc. and its U.S. subsidiary company, Velan Valve Corp., have the following credit facilities:

Unsecured Credit facilities available	Borrowing rates	Amount borrowed at May 31, 2003	2002
$19,106 (2002 – $19,584) (US$13,961; 2002 – US$12,817) (note 15)	Prime rate	$ -	$ -
$20,000 (US$14,615; 2002 – US$13,089) (note 15)	Prime rate	$ -	$ -
$500 (US$365; 2002 – US$327)	Prime rate	$ -	$ -
$5,000 – available to purchase readily convertible forward exchange contracts (note 15)		$ -	$ -

The above unsecured facilities are available by way of demand operating lines of credit, bank loans, letters of credit, bankers' acceptances, LIBOR loans, letters of guarantee and bank overdrafts. The above facilities are subject to annual renewal.

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

b) Foreign subsidiaries, a Canadian subsidiary and joint venture companies have the following credit facilities available:

Secured – By corporate guarantees

Credit facilities available	Borrowing rates	Amount borrowed at May 31, 2003	2002
Foreign subsidiaries			
CA$13,959 (2002 – CA$9,163) (€6,686; £300; KW1,600,000; NT$15,000) (2002 – €4,210; £400; KW1,800,000) (note 15)	2.63% to 8.25% (2002 – 3.84% to 7.75%)	$ 1,819	$ 2,265
Canadian subsidiary			
$600 (note 15)	Prime rate	$ -	$ -
Joint venture companies			
CA$1,968 (2002 – CA$1,863) (KW1,400,000; NT$8,250) (2002 – KW1,100,000; NT$10,500) (note 15)	3.75% to 7.10% (2002 – 5.25% to 8.00%)	$ 1,452	$ 1,505

The above credit facilities are available by way of bank loans, guarantees, letters of credit and forward exchange contracts. The majority of the above credit facilities have variable borrowing rates based on LIBOR, EONIA or prime rate. The borrowing rates listed above are the rates in effect at May 31. The terms of the above facilities range from annual renewal to indefinite term.

6 Accounts payable and accrued liabilities

	2003	2002
Trade payables and accruals	$ 37,121	$ 38,696
Affiliated company	143	54
Dividends	3,350	3,354
	$ 40,614	$ 42,104

7 Income taxes

The company's effective income tax rate is made up as follows:

	2003	2002
Basic Federal rate and surtax, less provincial abatement	29.12%	29.12%
Provincial tax rate	8.93	9.04
	38.05	38.16
Non-deductible foreign exchange on translation of integrated subsidiary companies	16.22	0.27
Non-deductible goodwill amortization	-	2.23
Manufacturing and processing deduction	(5.67)	(6.18)
Recognition of tax benefit arising from losses of subsidiary company, previously unrecorded	(3.47)	-
Utilization of previously unrecorded tax benefits of losses from subsidiary companies	(2.00)	(0.68)
Differences between Canadian statutory rates and those applicable to foreign subsidiary and joint venture companies	(2.00)	(0.85)
Permanent differences and other	(2.48)	2.42
	38.65%	35.37%

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

Future income taxes consist of the following amounts:

	2003	2002
Current	$ 2,057	$ 159
Non-current	(1,679)	(2,030)
Net future income tax asset (liability)	$ 378	$ (1,871)

The significant components of the net future income tax asset (liability) are as follows:

	2003	2002
Property, plant and equipment	$ (2,651)	$ (2,652)
Non-deductible reserves	1,354	1,099
Investment tax credits	(297)	(286)
Inventory	1,439	344
Tax losses	678	-
Other – net	(145)	(376)
	$ 378	$ (1,871)

Certain subsidiaries have accumulated losses for income tax purposes amounting to approximately $3,712, which may be carried forward to reduce taxable income in future years. The future tax benefit arising from these losses has been recognized in the accounts as a future tax asset. Of these unused losses for income tax purposes, $2,575 may be claimed in years no later than 2007 to 2023, and $1,137 may be claimed during an indefinite period.

8 Long-term debt

	2003	2002
a) **Velan Inc.**		
Loan from Société Innovatech du Grand Montréal (note 8(b))	$ -	$ 1,600
Government loans (note 8(b))	-	347
German subsidiary		
Bank loans (€323; 2002 – €352) (note 8(c))	521	502
Bank loan (nil; 2002 – €500) (note 8(c))	-	713
Korean subsidiary		
Bank loan (KW1,000,000) (note 8(d))	1,137	1,258
Portuguese subsidiary		
Loan (€228; 2002 – €403) (note 8(e))	367	575
Taiwanese joint venture company		
Loans (NT$13,991; 2002 – NT$7,554) (note 8(f))	638	344
Korean joint venture company		
Bank loan (KW376,000) (note 8(g))	427	473
Bank loan (KW900,000; 2002 – KW1,200,000) (note 8(g))	1,023	1,510
Other	443	372
	4,556	7,694
Less: Current portion	1,177	2,150
	$ 3,379	$ 5,544

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

b) **Velan Inc.**

Velan Inc. was granted a non-interest-bearing loan of $3,600 from Société Innovatech du Grand Montréal in connection with the development and manufacture of certain products. A payment of $1,800 was received in June 1996 and the balance in June 1997. Under the terms of the loan, a royalty of 3% of future sales of certain specified products from June 2005 to June 2010 will be payable to Société Innovatech du Grand Montréal.

Federal government loans received in prior years related to plant expansions consist of the following:

- Non-interest-bearing loan in the amount of $181 repayable in five annual instalments of $36 beginning in 2000.
- Non-interest-bearing loan in the amount of $434 repayable in five annual instalments beginning in 2001. The first instalment is in the amount of $68, followed by four subsequent instalments of $92.

Both loans were fully repaid during the year.

c) **German subsidiary**

Loans of $521 (€323) bear interest at rates of between 5.55% and 7.45%, which are repayable in maximum aggregate annual instalments of $84 (€52) including capital and interest until maturity in 2010 and 2011. The building, machinery and equipment have been pledged as security for these loans.

A bank loan of $713 (€500) bears interest at 5% and is repayable in fiscal 2003. The loan is secured by a letter of comfort from Velan Inc. The loan was repaid during the year.

d) **Korean subsidiary**

The Korean bank loan of $1,137 (KW1,000,000) bears interest at 5.9% and is repayable in annual instalments of $227 (KW200,000) until maturity in 2008. Certain buildings, machinery and equipment, and land are pledged as collateral for this loan.

e) **Portuguese subsidiary**

A loan of $367 (€228) is repayable in semi-annual instalments of $46 (€29) until maturity in 2007. The loan bears interest at LIBOR plus 0.78%; 73% of the interest is subsidized by government programs.

f) **Taiwanese joint venture company**

Loans of $638 (NT$13,991) bear interest at rates of between 4.50% and 7.77% repayable in maximum aggregate annual instalments of $51 including principal and interest. These bank loans have maturity dates ranging from 2004 to 2012.

g) **Korean joint venture company**

A bank loan of $427 (KW376,000) bears interest at LIBOR plus 0.2% (2002 – prime rate minus 2%) and is repayable in ten semi-annual instalments of $43 (KW37,600) commencing in 2006. Certain land is pledged as collateral.

A bank loan of $1,023 (KW900,000) bears interest at LIBOR plus 0.54% and is repayable in quarterly instalments of $171 (KW150,000) until maturity in 2005. Certain land, building, machinery and equipment have been pledged as collateral for the loan.

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

h) The following is a schedule of the future debt payments:

May 31,	2004	$ 1,177
	2005	1,036
	2006	457
	2007	489
	2008	379
	Subsequent years	1,018
		$ 4,556

9 Capital stock

a) Authorized – in unlimited number
Preferred Shares, issuable in series
Subordinate Voting Shares
Multiple Voting Shares (five votes per share), convertible into Subordinate Voting Shares

b) Issued

	2003	2002
6,575,701 Subordinate Voting Shares (2002 – 6,453,901) (notes 9(c) and (d))	$ 100,662	$ 101,018
15,756,567 Multiple Voting Shares (2002 – 15,906,567) (note 9(d))	8,932	9,017
	$ 109,594	$ 110,035

c) The company operates under a Normal Course Issuer Bid which entitles it to repurchase for cancellation a maximum of 348,310 Subordinate Voting Shares (2002 – 433,000) during the twelve-month period ending October 22, 2003. During the year ended May 31, 2003, 28,200 Subordinate Voting Shares (2002 – 2,400) were repurchased for a cash consideration of $396 (2002 – $33) and cancelled. Contributed surplus was credited with $45 (2002 – $4), being the amount by which the repurchase amount is below the stated capital of the shares.

d) During the year, 150,000 Multiple Voting Shares, with a stated capital of $85, were converted to an equivalent amount of Subordinate Voting Shares.

e) In 1996, the company established a fixed share option plan (the “Share Option Plan”) to allow for the purchase of Subordinate Voting Shares by certain full-time employees, directors and officers of the company and its subsidiaries at a subscription price equal to the reported closing price on the last business day before the day on which the option is granted. The total number of Subordinate Voting Shares which may be issued pursuant to the Share Option Plan will not exceed 1,250,000 shares, of which an aggregate 6,000 Subordinate Voting Shares have been issued. The granting of options is at the sole discretion of the Board of Directors who at the date of grant establishes the term and the vesting period. Vesting of options generally commences twelve months after the date of grant and accrues annually over the term providing there is continuous employment. The maximum term permissible is 10 years.

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

If the fair value based method of accounting had been used to account for the options granted subsequent to June 1, 2002, the company's net earnings and earnings per share would have been reduced to the pro forma amounts indicated below:

	2003	2002
Net earnings		
As reported	$ 7,388	$ 17,973
Pro forma	7,222	17,769
Basic and diluted earnings per share		
As reported	0.33	0.80
Pro forma	0.32	0.79

The fair value of the options is estimated as at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

Risk-free interest rate	4.2%
Expected dividend yield	2.0%
Expected life of the options	5.1 years
Expected volatility	25.0%

The weighted average fair value at grant date of the options granted during the fiscal 2002 year and which remain outstanding is $3.30.

The table below summarizes the status of the Share Option Plan:

	2003			2002		
	Number of shares	Weighted average exercise price	Weighted average contractual life (months)	Number of shares	Weighted average exercise price	Weighted average contractual life (months)
Outstanding – Beginning of year	167,000	$ 15.31	51.9	187,000	$ 18.75	6.8
Granted	-	-	-	147,000	13.73	-
Expired/forfeited	(6,000)	15.60	-	(167,000)	17.77	-
Outstanding – End of year	161,000	$ 15.30	35.9	167,000	$ 15.31	51.9
Exercisable – End of year	73,667	$ 17.43	-	30,000	$ 23.16	-

10 Earnings per share

Earnings per share is calculated using the weighted average number of shares outstanding of 22,342,246 (2002 – 22,361,233) and amounts to $0.33 (2002 – $0.80). The options do not have a dilutive effect.

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

11 Interest in joint venture companies

Below are the remaining balances included in the consolidated financial statements after eliminations emanating from our joint venture companies overseas.

	2003	2002
Consolidated balance sheets		
Current assets	$ 597	$ 985
Long-term assets	3,740	6,159
Current liabilities	2,420	1,465
Long-term liabilities	1,038	2,092

12 Segment disclosure

The company's operations are principally in the manufacturing and sale of industrial valves.

Geographic distribution of sales and assets

May 31, 2003	Canada	United States	France	Other	Consolidation adjustment	Consolidated
Sales						
Customers						
Domestic	$ 33,176	$ 124,752	$ 22,720	$ 10,991	$ -	$ 191,639
Export	53,016	-	14,095	24,722	-	91,833
Intercompany (export)	87,521	14,318	887	26,530	(129,256)	-
Total	$ 173,713	$ 139,070	$ 37,702	$ 62,243	$ (129,256)	$ 283,472
Property, plant and equipment	$ 28,834	$ 4,607	$ 3,486	$ 19,734	$ 588	$ 57,249
Goodwill	-	-	-	-	12,502	12,502
Other identifiable assets	129,283	74,957	39,873	26,853	(23,600)	247,366
Total identifiable assets	$ 158,117	$ 79,564	$ 43,359	$ 46,587	$ (10,510)	$ 317,117

May 31, 2002	Canada	United States	France	Other	Consolidation adjustment	Consolidated
Sales						
Customers						
Domestic	$ 34,275	$ 134,838	$ 21,989	$ 6,801	$ -	$ 197,903
Export	52,564	-	11,588	26,411	-	90,563
Intercompany (export)	102,149	13,075	-	20,728	(135,952)	-
Total	$ 188,988	$ 147,913	$ 33,577	$ 53,940	$ (135,952)	$ 288,466
Property, plant and equipment	$ 30,144	$ 5,013	$ 3,874	$ 17,256	$ 548	$ 56,835
Goodwill	528	-	-	-	12,502	13,030
Other identifiable assets	131,201	79,767	34,209	24,393	(20,031)	249,539
Total identifiable assets	$ 161,873	$ 84,780	$ 38,083	$ 41,649	$ (6,981)	$ 319,404

In 2003, no customer represented 10% or more of the company's sales. In 2002, one customer represented 12.9% of the company's sales.

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

13 Foreign exchange

a) Foreign exchange gains and losses realized on the translation of foreign currency balances and transactions during the year are included in cost of sales and amounted to:

	2003	2002
Actual net loss on translation of foreign currencies	$ 710	$ 211

b) Foreign exchange loss (gain) on translation of integrated foreign subsidiaries consists of:

	2003	2002
U.S. subsidiary	$ 5,570	$ (35)
Korean subsidiary	(442)	234
Taiwanese subsidiary	4	-
	$ 5,132	$ 199

14 Research expenses

Research expenses include the following:

	2003	2002
Research expenditures	$ 4,701	$ 4,358
Less: Scientific research tax credits	1,600	1,325
	$ 3,101	$ 3,033

15 Commitments and contingencies

a) In the normal course of business, Velan Inc. and its U.S., French, German, U.K. and Portuguese subsidiary companies issue performance bond guarantees related to product warranty and on-time delivery. The aggregate maximum value of these guarantees if exercised, as at May 31, 2003, amounted to approximately $14,313 (2002 –$14,566). These guarantees expire at various dates through the years to 2010.

b) Velan Inc. and its U.S. subsidiary company had outstanding purchase commitments with foreign suppliers amounting to $2,160 (2002 – $3,493) covered by letters of credit.

c) The Canadian, U.S., German and U.K. subsidiary companies had aggregate operating lease commitments for machinery and premises totalling $1,228 (2002 – $504).

d) The company enters into simple foreign currency forward contracts in order to hedge a portion of its foreign currency exposures. As at May 31, 2003, Velan Inc. contracted to sell US$7,500 (2002 – US$7,500) against the Canadian dollar, and the German subsidiary entered into contracts to sell €680 (2002 – €504) against the U.S. dollar. These outstanding contracts expire at varying terms to November 2003. The fair value of the contracts is determined by the exchange rate differential between the forward rate and the year-end spot rate. The fair value amounted to a gain of $565 (2002 – $358) and has been recorded in earnings as an offset to the loss on the hedged item (note 13(a)).

Notes to Consolidated Financial Statements

For the years ended May 31, 2003 and 2002 (in thousands, excluding number of shares and per share amounts)

e) The company's U.S. subsidiary has been named as one of the defendants in a number of asbestos related class action legal proceedings pertaining to products it formerly sold. Management believes it has a strong defence and has previously been dismissed, without making any payments, from a number of similar cases. Although at this time it is not possible to determine the outcome of these proceedings, based on the facts currently known to it, the company does not believe that the ultimate outcome will have a material adverse effect on its financial position, results of operations or liquidity. No provision has been set up in the accounts.

f) Lawsuits and proceedings or claims arising from the normal course of operations are pending or threatened against the company. Although at this time it is not possible to determine the outcome, based on the facts currently known to it, the company does not believe that the ultimate outcome will have a material adverse effect on its financial position, results of operations or liquidity. No provision has been set up in the accounts.

g) The company has committed to purchase an additional 25% interest in a start-up valve manufacturer located in Italy for a cash consideration of $597 (€370). The company will own a 50% interest in this start-up valve manufacturer when the purchase is finalized and it will be accounted for using the proportionate consolidation method.

16 Transactions with affiliated companies

Transactions with affiliated companies in the ordinary course of business, which are measured at the exchange value and are not otherwise disclosed separately in these financial statements, are as follows:

	2003	2002
Purchases from an affiliated company		
Material components	$ 1,946	$ 2,864
Machinery and equipment	1,078	181
Amounts charged by an affiliated company		
Computer consulting	229	29
Advance to an affiliated company		
The advance is non-interest bearing, secured by machinery and equipment and repayable by no later than May 31, 2004.	280	-

One affiliated company sold material components and machinery and equipment to the company and is owned by certain relatives of the controlling shareholder. This is the same affiliated company which received the advance. A separate affiliated company provided computer consulting services to the company of which a different relative of the controlling shareholder owns a 50% interest therein.

Corporate Directors

I. C. Velan	Chairman of the Board and Executive Vice-President, North American Sales
S. MacCulloch	Director
M. Vineberg	Director
P. O. Velan	Director
A. K. Velan	Chief Executive Officer
T. C. Velan	President

Corporate Officers

A. K. Velan	Chief Executive Officer
T. C. Velan	President
I. C. Velan	Executive Vice-President, North American Sales
S.R. Farrell	Executive Vice-President, Finance and Information Technology, Chief Financial Officer and Corporate Secretary
R. Bose	Executive Vice-President, Engineering, Quality Assurance, Research & Developement, Total Process Improvement and Field Engineering Service
P. Dion	Vice-President, Canadian Sales
E. François	Vice-President, Quality Assurance
P. Lee	Vice-President, Sales - United States (Eastern Division)
G. Perez	Vice-President, Marketing
C. Pogue	Vice-President, Sales - United States (Western Division)
F. Saliba	Vice-President, Information Technology
R. Sargent	Vice-President, International Marketing
A. Smith	Vice-President, Procurement and Overseas Manufacturing
G. Zarifah	Vice-President, Production
M. Zivic	Vice-President, International Sales

Head Office

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Chief Financial Officer and Corporate Secretary

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Auditors

PricewaterhouseCoopers LLP

Transfer Agent

CIBC Mellon

Shares Outstanding as at May 31, 2003

6,575,701 Subordinate Voting Shares
15,756,567 Multiple Voting Shares

Listing

Symbol: VLN TSX

Price Range

High $18.00
Low $10.00

Closing on May 31, 2003: $11.90

Annual Meeting

The Annual Meeting of Shareholders will be held November 20, 2003 at 11:00 a.m. in the Saint Charles Room of:

The Delta Centre-Ville
777 University
Montreal, Quebec

Dividend Policy

The Company has instituted a dividend policy of $0.30 annually per share, payable semi-annually. Any future change to this policy will remain at the discretion of the Board of Directors of Velan and will depend on the Company's financial condition, results of operations, capital requirements and such other factors as the Board of Directors deems relevant.

Velan was an official sponsor of the Valve World 2002 Expo, a conference for valve and piping specialists in the Netherlands which included a keynote speech by A.K. Velan.

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